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July 19, 2004

VIA HAND DELIVERY

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 3rd Floor
Boston, MA 02110

Re: Direct Energy's Responses to First Set of Information Requests, D.T.E. 04-01

Dear Secretary Cottrell:

Enclosed please find for filing in the above-captioned proceeding an original copy of Direct Energy's responses to the First Set of Information Requests. An electronic copy has also been filed.

Please date stamp the enclosed copy of this letter and return it for our files.

Thank you for your assistance.

Very truly yours,

John A. DeTore
Rebecca L. Tepper

Enclosures
cc: Caroline M. Bulger, Hearing Officer *(1 Copy)*
Jody Stiefel, Hearing Officer *(1 Copy)*
Andreas Thanos, Assistant Director Gas Division *(5 Copies)*
Service List

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

INVESTIGATION BY THE DEPARTMENT OF TELECOMMUNICATIONS AND ENGERY ON ITS OWN MOTION INTO THE ASSIGNMENT OF INTERSTATE PIPELINE CAPACITY	))))))	D.T.E. 04-01

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the following document: Direct Energy's Responses to the First Set of Information Requests of the Department of Telecommunications and Energy upon all parties of record via first class mail, in accordance with the requirements of the Department's rules of practice and procedure as set forth at 220 C.M.R. §1.05(1).

Dated at Boston, Massachusetts this 19th day of July, 2004.

Rebecca L. Tepper
Rubin and Rudman LLP
50 Rowes Wharf
3rd Floor
Boston, MA 02110
Telephone: (617) 330-7000

Dated: July 19, 2004

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

FIRST SET OF INFORMATION REQUESTS TO
DIRECT ENERGY MARKETING, INC.
D.T.E. 04-01
July 19, 2004

Respondent: Patrick Jeffery

DE-1 Refer to Direct Energy reply comments at 7-13. Please discuss any problems with the implementation of the path approach in New York and Rhode Island, including possible problems with the over-subscription of a particular path(s) by marketers. How did New York and Rhode Island address these problems?

Response: 1. It is Direct Energy's understanding that Rhode Island has not had any problems with over-subscription of a particular path by marketers. In Rhode Island, for instance, New England Gas Company each year allows marketers to prioritize the available pipeline paths. Last year, each marketer selected 4 of 6 listed paths indicating preference by numbering 1 to 4, with 1 being the first preference. Marketers may retain their current path at its existing level or select a new path. Marketers also have the option to treat existing and new customers differently (*i.e.*, they may assign existing and new customers to the new path selected or request that new customers only be assigned the new path and existing customers stay with the existing path). Additions are assigned based on availability and marketers with existing paths retain first right of refusal on their current level of capacity on that particular path. In the event that a path becomes over-subscribed, assignments would be made on a pro rata basis. *See New England Gas Company, Rhode Island Public Utilities Commission Tariff No. 101, Section 6, Transportation Terms and Conditions, Schedule C.* However, it is Direct Energy's understanding that New England Gas Company has not had any paths become over-subscribed.

It is Direct Energy's understanding that in New York over-subscription is not a problem because, unlike Rhode Island, the LDCs in New York assign particular paths to marketers, rather than having the marketers select or prioritize paths themselves. *See e.g.,* Orange and Rockland Utilities Inc., Service Classification No. 11, and Gas Transportation Operating Standards, February 17, 2004.

Direct Energy believes that the marketers, working in conjunction with LDCs, can develop business processes and terms that would provide a means for resolving any over-subscription issues that might arise. One potential approach is to implement a program similar to Rhode Island's where each LDC would develop available paths (including volumes) each year. Marketers would then provide the LDC with their preferred paths, including 1st and 2nd (and more, if necessary) alternatives to be used in the event their preferred path(s) are "over-subscribed".

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Respondent: Patrick Jeffery

DE-2 Refer to Direct Energy reply comments at 7-13 and Bay State reply comments at 6. Please address: (a) how the path approach addresses the "non-price differentials" as discussed by Bay State, and (b) what measures can be taken to either eliminate or reduce the risk of leaving higher-cost capacity to the LDCs to serve the sales customers.

Response: 2. Please see Direct Energy's response to DTE-2-1.

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Respondent: Patrick Jeffery

DE-3 Refer to Direct Energy reply comments at 13-14. Please discuss any problems with the implementation of the annual recall and re-release of capacity in New York. How did New York address these problem?

Response: 3. Direct Energy does not have specific knowledge of problems with the implementation of the annual recall and re-release of capacity in New York.

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Respondent: Patrick Jeffery

DE-4 Refer to Direct Energy reply comments at 5-7.

(a) What is the assurance that the capacity that LDCs transition to marketers under a voluntary capacity assignment system as proposed by Direct Energy will remain available to Massachusetts LDCs if the marketers decide to exit the Massachusetts market?

(b) Discuss the voluntary capacity assignment system as it operates in New York and any other state regarding the disposition and re-awarding of capacity held by marketers who exit those markets.

Response: 4. (a) As noted in Direct Energy's Reply Comments and in its response to DE-8 below, Direct Energy believes that Massachusetts should have a long-term goal of introducing a voluntary capacity assignment program. The issue of exiting the market is one of the issues that the Department can explore further as it continues to work towards that goal. One option would be for LDCs and marketers to address this issue via contractual arrangements which may include provisions for a reassignment of capacity to the LDC if another supplier cannot be found to purchase that capacity. As Direct Energy stated in its Reply Comments, however, it believes the Department's immediate objective should be to implement modifications to the current capacity assignment system – changes specifically designed to mitigate administrative costs and the risk imposed on new entrants to the Massachusetts gas market.

Thus, Direct Energy encourages the Department to address the issues related to capacity assignment in two phases. In the first phase, the Department would implement the changes to the current capacity system advocated by the marketers in this proceeding including a change to the path plus credit/surcharge approach. In the second phase, the Department would open a rulemaking proceeding designed to address comprehensive solutions to the structural barriers to competition in the mass markets including the introduction of a voluntary capacity system and consideration of a retail auction and further rate unbundling.

As Direct Energy stated in its Reply Comments, the Department should seek to implement the first phase in time for the 2004-5 winter season. In order to do so, Direct Energy suggests the following procedural schedule: (1) the Department immediately orders the LDCs to submit proposed tariffs implementing the path plus credit/surcharge approach and modifying the non-daily metering program within 21 days of the Department's order for the Department's review and approval; (2) the Department suspends the LDCs' tariffs until November 1, 2004 and conducts a consolidated proceeding to review and receive comments on the tariffs; (3) the Department issues an order on the proposed tariff changes by October 31, 2004 and if it approves them, allows them to go into effect on November 1, 2004. With this schedule, all parties could plan for the 2004-05 winter season and the Department would ensure that the changes to the system would be in effect this winter.

After phase one is completed, Direct Energy suggests that the Department turn to the longer term goals of phase two and open a rulemaking proceeding in January 2005 designed to address comprehensive solutions to the structural barriers to competition in the mass markets including a change to a voluntary capacity system and consideration of a retail auction and further rate unbundling. See response to DE-8. Direct Energy proposes that the Department set the goal of issuing proposed regulations by July 2005, with final rules being issued in September 2005.

(b) It is Direct Energy's understanding that in New York, if a marketer who obtains capacity from the LDC exits the market, that marketers' released capacity is returned to the LDC.

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Respondent: Patrick Jeffery

DE-5 Refer to Direct Energy reply comments at 5-7. What are FERC's regulations governing the award of capacity to shippers in the primary and secondary markets? Provide copies of the FERC regulations governing the award of capacity to shippers in the primary and secondary markets.

Response: 5. Please see the following website: http://www.ferc.gov/legal/ferc-regs/land-docs/RM98-10-005.asp. This website contains FERC's Final Rule in Docket Nos. RM 98-10-000 and RM 98-12-000, Order No. 637, that pertains to the regulation of short-term natural gas transportation services and regulation of interstate natural gas transportation services. In Order 637, issued on February 9, 2000, FERC amended its regulations in response to the growing development of more competitive markets for natural gas and the transportation of natural gas. In particular, see 18 CFR 284 - Certain Sales and Transportation of Natural Gas Under the Natural Gas Policy Act of 1978 and Related Authorities. *See* www.access.gpo.gov/nara/cfr/waisidx_04/18cfr284_04.html for a copy of this regulation.

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Respondent: Patrick Jeffery

DE-6 Refer to Direct Energy reply comments at 10. Please discuss any structural differences (e.g., size of market, number of interstate pipelines, storage facilities, regulatory framework, etc.) between the natural gas markets in Massachusetts, New York and Rhode Island. Identify all the interstate pipelines (mainline pipelines) and citygates that serve each market.

Response: 6. Direct Energy has already discussed some of these structural differences in its Reply Comments, specifically those related to the regulatory framework for capacity release from LDCs to marketers. New York has adopted a voluntary capacity assignment regime utilizing the path approach and Rhode Island has adopted the path with credit/surcharge approach that Direct Energy recommended in its Reply Comments. In addition, the New York market has more customers, more LDCs, more pipelines and more receipt and delivery points than Massachusetts. Rhode Island has fewer customers, only one LDC and only one pipeline, making it less complex than Massachusetts. However, in addressing the issue of capacity assignment, the issue facing the Department is identical to the issue that faced the Commissions in New York and Rhode Island: how to develop the most efficient means of allocating the control of and cost responsibility for those supply assets acquired by the LDCs without creating cost inequities. Clearly, the actual process and terms under which a more balanced approach to capacity assignment could be implemented would need to address the unique nature of the Massachusetts market. But the differences in the number and size of the LDCs in each state, and the fact that those LDCs have developed portfolios tailored to their specific needs, would not prevent either the path approach, in the near term, or the voluntary assignment approach, in the long term, from being implemented in Massachusetts.

The pipelines serving New York are Dominion, Transco, Tennessee, Iroquois, Empire, Algonquin, Texas Eastern, Columbia Gas Transmission and National Fuel.

Rhode Island is served by Algonquin and Tennessee as is Massachusetts. Massachusetts is also served by Maritimes & Northeast, Granite State, and Portland Natural Gas.

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Respondent: Patrick Jeffery

DE-7 Please explain the reasons why competitive suppliers do not serve, as a general basis the residential and small C&I segments.

Response: 7. The value sufficient to attract mass market customers can take several forms. Some customers may be interested only in beating the LDC's price; others may be interested in supply products with features that enhance the level of service provided by the LDC (for example, price stability, cost control, or an ability to provide "risk managed" products). Marketers would be pleased to provide such value to mass market customers but, unlike LDCs, marketers are not guaranteed a rate of return, much less a minimum level of return. In the Massachusetts market as it exists today, a number of factors have prevented marketers from being able to offer valuable services to mass market customers on terms that allow them to stay in business. These factors include:

1) <u>The high fixed costs of assigned capacity under the Department's current rules make the residential and small business sectors difficult to serve</u>. Residential heating customers have low-load factors, and the high fixed costs of assigned capacity assets make the residential segment less desirable than higher load factor C&I customers. The administrative burden associated with the slice-of-system approach to capacity assignment represents a challenge in serving even large C&I customers, but it is a market-killer in the residential and small business sectors.

2) The LDCs enjoy several structural advantages that marketers cannot overcome in the residential and small business sectors:

a) The data exchange requirements that LDCs are allowed to impose on marketers are cumbersome and are not uniform among the various LDCs. This results in a serious disadvantage to marketers who must deal with multiple systems for usage acquisition, enrollment and termination, and billing.

b) The inertia inherent in the incumbent's position makes it very difficult to win residential and small business customers away one at a time. Acquisition costs (which are zero for LDCs) are high for marketers and there are effectively no opportunities for scale entry into the mass markets that would allow marketers to reduce those costs.

c) The LDC also enjoys advantages in its cost structure because it provides back-office services (billing, payment processing, collections, customer service, etc.) for two products, supply and delivery. Marketers, however, must replicate these functions for a single service, supply. When a marketer wins a customer away from the LDC, the marketer is given no credit for any costs the LDC avoids (or should avoid) for providing supply to that customer. The marketer's customer, in effect, pays twice for those services, once to the marketer and once to the LDC in the LDC's delivery rates. Therefore, marketers must not only offer competitively priced supply service, but also must be far more efficient than the LDC in its back-office operations in order to overcome the rate structure advantage of the LDC.

3) <u>High Performance Security/Credit Costs</u>

a) Under current rules, marketers are required to meet stringent credit requirements imposed by multiple parties, and are usually required to post some form of payment security to:

i) Commodity suppliers,
ii) Financial institutions (for, *e.g.*, NYMEX futures accounts),
iii) Pipeline companies, and
iv) LDCs

These costs are, to a great extent, fixed at least at a minimum level, and can be very difficult to spread over a small group of low load factor residential or small business customers.

With sufficient cooperation from the LDCs and creative solutions from the Department, these incumbent advantages could be minimized but until then, the residential and small business markets are not likely to be attractive to marketers.

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Respondent: Patrick Jeffery

DE-8 Please discuss fully the following issues:

(a) potential regulatory policies that the Department could implement to encourage competitive suppliers to serve the residential and small C&I segments;

(b) how the voluntary capacity assignment and the path approach could spur competition at the residential and small C&I retail markets.

Response: 8. (a) and (b) Creating competitive options for residential and small business customers would require policy changes that overcome the structural barriers discussed in response to DE-7. In the larger C&I market, regulatory changes that result in incremental improvement to supplier cost structures could result in a significant increase in supplier activity. For example, the reduction in administrative burdens and the associated costs that would result from moving to the path approach for capacity assignment in the near term and to voluntary capacity assignment in the long term would, alone, make the large C&I market much more attractive to competitive suppliers.

In the residential and small business markets, however, incremental improvement is unlikely to result in any significant increase in supplier activity. The combination of high fixed costs, high acquisition costs, and inherent incumbent advantage render the mass markets relatively impervious to single element solutions. Lowering administrative costs by moving in the near term to a path approach for capacity assignment would be a great benefit for the large C&I market but, alone, might have little or no effect on the mass markets. A bolder approach that addresses multiple barriers simultaneously may be required to create a robust market for residential and small business customers.

Direct Energy believes that the framework for such a bold approach already exists. In January 2004, Representative Dan Bosley, the House co-chair of the Joint Committee on Government Regulations, presented a proposal with the express goal of bringing the many benefits of competition to residential and small business customers in the electricity markets. Since then, Rep. Bosley has been joined by his Senate counterpart, Sen. Michael Morrissey, in presenting a joint legislative proposal for the introduction of competition in the mass electricity markets. The proposal is under active consideration by the two co-chairs. Direct Energy wholeheartedly supports this proposal and believes that its basic framework would also provide an excellent framework for a competitive gas market for residential and small business customers.

Full implementation of a version of the Bosley-Morrissey plan for the residential and small business gas markets would likely require legislative action. However, Direct Energy believes that the Department could implement two key elements of the plan under its current authority and that these two elements would address the most significant barriers to entry discussed in response to DE-7.[1] These two elements are:

- A retail auction of the right to serve residential and small business customers, and
- Further rate unbundling that would ensure that costs LDCs can or should avoid when customers migrate to transportation-only service do not continue to be collected in the LDC's delivery charges.

[1] It is unlikely that the Department could require LDCs to structurally separate their supply and delivery functions in the manner that the original Bosley plan would have required electric utilities to structurally separate their retail and distribution functions. However, even under the Department's current standards of conduct, an LDC choosing to participate in a retail auction for the right to serve residential and small business customers would have to ensure that its retail operation enjoyed no competitive advantage from its affiliation with the delivery arm of the company.

In the context of the gas markets, the advantages are clear: these measures would address the most significant barriers to entry discussed in response to DE-7 while bringing value and innovation to residential and small business customers. The specific advantages of this approach include:

- <u>Opportunity for scale entry</u> – An auction creates immediate opportunities for competitive suppliers (including those affiliated with LDCs) to enter the mass markets with sufficient scale that they can overcome the high cost of acquiring residential and small business customers one at a time.

- <u>Level playing field among retail providers</u> – The combination of a retail auction and further rate unbundling removes the most significant inherent advantages enjoyed by the incumbent LDC in the mass markets – monopoly market share and the ability to spread back-office costs over two services.

- <u>Momentum toward further competition</u> – Once a properly designed retail auction brings more competitive suppliers into the market with a certain level of scale, these suppliers immediately begin competing with each other to maintain or improve their market position. The result is better pricing and more innovative services for customers.

To be sure, there are key differences between the gas and electricity markets and any plan for an auction of the right to serve mass market customers would have to address these differences. Most importantly, there is no single, independent entity that is responsible for reliability in the gas markets as there is in the electricity markets. Each LDC is responsible ultimately for the reliability of the gas supply to its customers. There is no reason to believe, however, that the high level of migration achieved by a retail auction of mass market customers would compromise reliability if done properly and with close coordination among the LDCs, competitive suppliers, and the Department. Indeed, one gas utility, Dominion East Ohio ("DEO"), has seen a sufficiently high percentage of its mass market customers (approximately 60 percent) migrate away from utility gas supply that DEO is considering, on its own initiative, exiting the merchant function. The DEO experience is strong evidence that reliability and robust competition in the mass markets are not mutually exclusive so long as all market participants approach the unique challenges of creating competition in the gas markets with open minds and in good faith.

It is essential for the Department to move forward with the near-term policy changes that Direct Energy and others have recommended to change from "slice of system," to "path" allocation of capacity, which would have an immediate positive effect on Massachusetts C&I gas markets. Direct Energy recommends that the DTE adopt the schedule for further action proposed by Direct Energy in DE-4 (a), which would accomplish this immediate goal. In the second phase of the recommended schedule, however, Direct Energy encourages the Department to move beyond consideration of the capacity assignment issue and take up the issue of more comprehensive solutions to the structural barriers to competition in the mass markets. This discussion should include consideration of a retail auction and further rate unbundling such as that proposed in the Bosley-Morrissey Plan for the electricity market.

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Respondent: Patrick Jeffery

DE-9 Please provide a list of the entry barriers in the retail Massachusetts market.

Response: 9. Please see Direct Energy's response to DE-7.

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Respondent: Patrick Jeffery

DE-10 Under the competitive suppliers' experience, what should the minimum savings offered by competitive suppliers be in the commodity portion of the customers' bill in order to encourage customers to migrate to transportation service?

Response: 10. Customers make decisions regarding savings requirements that will encourage them to migrate to transportation service and do so for any number of reasons. These reasons can include factors in addition to cost savings such as services provided by the marketer, certainty of price or risk management. Such factors are also relevant when customers switch between marketers.

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Respondent: Patrick Jeffery

DE-11 Please discuss the minimum scale necessary (in terms of volume and / accounts) to maintain profitable retail operations in the gas Massachusetts market.

Response: 11. Because each marketer's objectives and operating costs differ, there is no single volume or number of accounts that will ensure a profitable retail operation in the Massachusetts gas market. The size of the customer, the efficiency of the marketer's operations, and the marketer's fixed costs all contribute to a determination of such a scale. Of course, reductions in administrative costs and risk imposed on new entrants can reduce the minimum scale for successful operations. *See also* Direct Energy's response to DE-7.

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Respondent: Patrick Jeffery

DE-12 Please provide a Table with the number of monthly contracts stranded due to their small size since 1999 to January 2004 as well as the total MDQ associated to them, and the monetary value of them.

Response: 12. Because Direct Energy is a potential new entrant into the Massachusetts market, it does not have any data detailing stranded capacity.

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Respondent: Patrick Jeffery

DE-13 Direct Energy reply comments at 10 states that the Rhode Island Path model is instructive because while it utilized a mandatory capacity allocation system, it allows marketers to select capacity paths from those posted on an annual basis. In this regard, please:

(a) discuss any structural differences (e.g., size of customers, pipelines serving) between the natural gas Massachusetts market and the natural gas Rhode Island market;

(b) specify all the interstate pipelines and city gates serving Rhode Island market.

Response: 13. Please see Direct Energy's response to DE-6.

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Respondent: Patrick Jeffery

DE-14 Please discuss and fully support your answer with respect to the reduction in the number of marketers since 1999 up to today. Is it because consumers decide to migrate back to the LDC or it is because marketers leave the system and as a result, customers have to go back to default service?

Response: 14. Because Direct Energy is a potential new entrant into the Massachusetts market, it does not have direct experience with Massachusetts customers. Direct Energy has found in its experience in other states, that customers with competitive contracts tend to be satisfied with their arrangement so long as the marketer operates in accordance with the parties' agreement. When customers return to LDC service, it tends to be because the marketer has left the system.

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Respondent: Patrick Jeffery

DE-15 Refer to Bay State reply comments at 6. Please address: (a) how the path approach addresses the "non-price differentials" as discussed by Bay State, and (b) what measures can be taken to either eliminate or reduce the risk of leaving higher-cost capacity to the LDCs to serve the sales customers.

Response: 15. Please see Direct Energy's response to DE-2 and DTE-2-1.